How can economic cohesion be achieved and maintained in a heterogeneous currency area with a low degree of federalism?

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Introduction

In countries that share a single currency, economic policies are a point of common interest. The 2008 – 2009 crisis showed us that local fragilities quickly become everyone's problem and that the European Monetary Union does not by itself create economic convergence.

The Eurozone is a currency area comprising heterogeneous countries (their productivity levels, their productive specialisations, the level of labour force skills are different) with a low level of federalism. The Greek crisis is now inviting us to think deeply about the type of economic policy rules to be followed by Member States within such a currency area.

Without substantial financial solidarity (the EU budget is scarcely more than 1% of GDP), only States that achieve lasting compliance with the rules of the Stability and Growth Pact and the Fiscal Compact and that accept that real wage growth should not outpace productivity gains to avoid a deterioration in their competitiveness, may share the same currency. When economic shocks occur, each country needs a flexible economy and sufficient fiscal buffers to cover the economic cycle.

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I. Is it possible to have countries with very different per capita incomes in a monetary union?

The euro area is a monetary union with countries whose per capita incomes are very different. The gaps are considerable: between Germany and the countries with the lowest per capita incomes (Portugal, Greece, Slovenia, Latvia, Lithuania, and Slovakia), there was a ratio of 1 to 2 in 2014.

Countries with very different per capita incomes can be grouped in a monetary union such as the euro area. But this is possible only if nominal wage increases correspond to productivity increase. The purchasing power catch up can therefore take place only at the same pace as the productivity catch up. In sum, the convergence of living standards cannot happen faster than the increase of per capita productivity [1].

Indeed, in a system of "no bail-out" such as that of the Maastricht treaty, balances of payments remain national. The euro area is not a federal state. Any attempt by the poorer countries to obtain a faster catch up of purchasing power than their gains in productivity would lead to a loss of competitiveness and a crisis. Constant borrowing by the low-income countries from the high-income countries in order to consume more than they produce – as was the case in the euro area until 2008-2009 [2] – is not a solution as it inevitably leads to external solvency crises.

This analysis makes it possible to illustrate the reasons behind the Greek issue and how it came about: until 2010, real wage growth was chronically higher than productivity growth. From 2001 to 2010, Greece's unit labour costs increased by an average of 3% per year, while Germany saw an annual increase of only 0.4%. As a result of this, prices rose more quickly in Greece (+3.4%) than for its neighbours (1.6% for Germany over this period); this resulted in a sharp decline in Greek competitiveness; its current account deficit reached 13% of GDP in 2007 and 15.4% in 2009. Normally a relatively unproductive economy like Greece is forced to moderate its domestic demand and "live within its means". However, from 1998 to 2009, this did not happen. The euro's existence encouraged capital flows. Indeed, during this decade, capital inflows offset its external deficits as if the drachma's disappearance had enabled the Greek risk to disappear as well, with the consequences that we are well aware of...

How can macroeconomic imbalances be corrected in a union characterized by the no bail out rule?

The correction in divergences in competitiveness in a monetary union can only be achieved through the "internal devaluation" meaning through cuts in labour costs and real wages provided the country has sectors that are large enough to benefit from this improvement of competitiveness and has a limited level of public indebtedness.The Baltic countries, Ireland, Spain, Portugal experiences were successful in this respect. But ongoing fiscal adjustment and discipline have their limits. They may boost exports for a while, but this often leads to a fall in domestic demand, which contributes towards bringing down nominal GDP and pushing up debt ratios and further depressing demand, which is costly in terms of activity and employment. In addition, that is not automatically going to create a durable offsetting process of job creation in export-led sectors, unless policies tackle the deeper structural imbalances that have crippled external accounts.

That is why European assistance to support efficient local private investment and protect useful public capital expenditure would be relevant in the countries affected by macroeconomic imbalances and which are making the essential structural adjustments needed to restore their competitiveness. This would involve an increase in the size of the EU's budget with larger and better invested structural funds and an increase in the size of the Juncker Plan for the financing of investments in countries undergoing adjustment reforms.

A monetary union does not, by itself, create economic convergence.

A monetary union tends to concentrate economic prosperity in certain regions that are better endowed with productive capital and human resources. Indeed, the elimination of foreign exchange risks fosters greater capital mobility which, in turn, encourages productive specialization within the zone.

The two normal levers to cope with the inevitable specialization effect are well known:

First, labour mobility is an essential ingredient of an effective monetary union: populations of sub regions with fewer growth prospects tend to move to more dynamic parts of the union.

The other correcting factor to reduce income differentials between countries is public transfers. In the United States, for instance, individual states must present balanced budgets. But in fact, a significant part of public expenditures is federal. This buffer does not exist in euro zone countries.

Of course it is not possible to replicate 18 Germanies in the euro area. In all large diversified monetary unions (as in the United States), there are inevitably different levels of productivity by regions. This is also true within individual countries of the Eurozone.

The absence of rapid income convergence on the back of productivity gains and the insufficient degree of federalism and labour mobility explain why the heterogeneity of Eurozone countries is producing tensions between them.

Under normal circumstances, the Eurozone's low-income countries, such as Greece, Portugal and Spain, should have benefited from their Eurozone membership to increase their capital, productivity, potential GDP and per capita income levels. Their additional debt (domestic and external) should have been offset with additional effective capital and not additional consumption, current public spending or financing for a property bubble. Economic analysis shows that a large proportion of the external debt taken out by these countries has financed unproductive spending: property bubble, current government spending. This "misuse of the Eurozone" by the peripheral countries accounts for the reluctance of the core countries, since 2008, to lend them more and notably to Greece.

In such a context, a collective monitoring of competitiveness should be set up without any delay not only to avoid some countries allowing their cost competitiveness to deteriorate.

Despite reforms of the euro governance significant discrepancies can still be observed in the Eurozone.

The creations of the European Stability Mechanism[4], a permanent sovereign crisis resolution mechanism and the Outright Monetary Transactions (OMT) programme of the ECB have reducedunquestionablythe vulnerability of the currency union. The implementation of the Banking Union - Single Supervisory Mechanism (operational since November 2014), Single Resolution Mechanism (operational in 2016) and harmonised deposit insurance – is also making the banking system of the euro area more resilient. Moreover, the launching of the Capital Markets Union is relevant. It will ensure more diversified sources of financing so that companies, including SMEs, can tap capital markets and access other sources of non-bank finance in addition to bank lending.The hurdles that may deter institutional and retail investors from participating fully in the capital markets are a key issue in this regard.

The EU reforms of fiscal and economic surveillance are less successful. Following the EU crisis, EU governments indeed adopted more binding rules for national economic policies to avoid economic discrepancies: six pack, two pack, and Treaty on Stability, Coordination and Governance. With the introduction of the Macroeconomic Imbalance Procedure, Macroeconomic surveillance was strengthened and expanded beyond the fiscal domain.

Nonetheless, apart from a limited group of core countries, significant discrepancies can still be observed in the Eurozone for structural reasons:

- In France, the percentage ratio of public expenditure to GDP (57%) in 2014 was significantly higher than the German Spanish figures of less than 45%
- The level of public debt compared to GDP is still increasing in most euro countries (except in Germany, Ireland, and Belgium)
- Total employment is close to 75% of working age population in Germany while it is 64% in France, and 55% in Spain and Italy.
- The unit labour costs are very divergent (on a 100 basis in 2000, Germany =115, Italy=140, France & Spain =130)
- The profit operating margins (measured by Ebitda as a percentage of value added) are also divergent: France is less than 30%, Germany = 43%, Euro zone average = 37%.
- The flexibility of the labour market is very diverse in the euro zone although this is the key to the resumption of employment.

Thus, differences in the exposure of Member States to shocks have persisted and adjustment capacity to shocks has remained insufficient in many countries. This is worrisome since the sluggish medium-term growth prospects and the proximity to the zero-lower bound are likely to test member States' adjustment capacity in the coming years.

Moreover, since the 2008-2009 crisis, internal capital mobility has stopped inside the Eurozone: the core Eurozone countries with a surplus have lent their surplus savings to the rest of the world and not to the other Eurozone countries and therefore theses surpluses have not been used to finance investments in the euro area. This is reducing the capacity of peripheral countries to invest as well as their potential growth.

In addition, the strengthening of the fiscal and macroeconomic surveillance frameworks does not prevent the existence of a significant structural heterogeneity of the countries due to different productive specialisations and hence a divergence in income growth from one country to another.

II. How should we conceive reforms that could, in the long run, make the Union viable?

We would suggest, on the basis of the above analysis, that the conditions for a more harmonious and viable monetary union in Europe should be conceived on the following lines:

1. First fiscal discipline must become a tangible reality in all parts of the Union

A monetary union is not workable without fiscal discipline. No responsible state will or should ever accept financing current public deficits generated by other Eurozone members of the Union that do not follow the rules of the Union. That would never work politically on a lasting basis. All countries must reach balanced budgets within a realistic – but relatively short (2 to 3 years) timetable. Recommended measures must give priority to cost reductions versus tax increases in order not to harm economic growth. A significant amount of public expenditures does not foster growth. This is why the ineffective expenditure sectors should be the first to be cut back.

The European Institutions must also ensure that common rules are thoroughly and evenly applied. The Commission's controls to ensure compliance with fiscal rules have proven to be ineffective since 2003. Ultimately, it is now essential that the Commission, the guardian of the treaties, ensures compliance with the fiscal rules that the Member States have committed to. If not confidence in the stability and the continued existence of the euro is seriously threatened.

2. Structural measures toward increasing growth potential should be encouraged and monitored

There is no other way than structural measures to sustainably raise output and productivity growth, reduce competitiveness problems and recourse to debt. Countries with the highest unemployment rates are indeed the ones where labour market regulation is the most rigid. Lower oil prices and lasting low interest rates provide a unique opportunity for implementing such reforms and should not be wasted.

Eurozone regular discussions and monitoring exercises should cover not only fiscal performance, but also macroeconomic policies, as well as competitiveness issues, encompassing competition rules, business operating margins, labour market flexibility reforms (work time flexibility, unemployment benefits, ability to let social partners negotiate salaries in businesses in line with the economic climate, etc.).

Today, the European semester analyses are too complex; the macroeconomic imbalances procedure is being held back because it cannot count on one key indicator, as well as guidelines that are not sufficiently prioritised and rarely discussed at national level.

Ensuring in Europe that instead of a sluggish growth of 1,5%, we have 2,5% or 3% so that more jobs can be created requires considering productivity and competitiveness rates across Europe. We need to lay down competeveness targets for 3 to 5 years. For example if the company profit margins for French companies for instance are X and they should be X+Y to achieve the European average, it could be agreed, politically speaking, that France would aim to achieve that target within 3 to 5 years because these margins determine the rate of employment. With this kind of approach there would be "ownership" i.e. making the European rules our own, by necessity.

Regular dialogue looking at competitiveness gaps and divergent trends between Eurozone members should therefore be established as soon as possible between Europe's institutions and Eurozone Member States. For States lagging behind the European average for competitiveness, this should result in commitments focusing on a limited number of structural reforms. This approach should make it possible to reinforce the level of engagement among national parliaments, social partners and the civil society for structural reform programmes.

Agreements could be drawn up setting out these commitments for Member States and combined with incentives to support and facilitate these reforms provided that they are effectively implemented. More controls would be justified to ensure that the European money paid in is effectively used to support the adjustment process.

3. Proposal for a European Savings Investment Fund (ESIF) to better allocate savings across Eurozone member states

Another way of fostering growth and progressing toward more economic cohesion within the euro area is channelling surplus savings of some euro zone countries to areas where investment deficit prevails. Since cross-border private lending is still limited, Northern savers accumulate domestic bond holdings and bank deposits earning zero nominal returns while investment in southern countries is constrained by the diminished savings available locally.

In this perspective, the creation of a European Savings Investment Fund has been proposed to use euro area excess savings to fund euro area investment deficit.

Such a Fund would offer long maturity savings bonds to euro area households and life insurance companies with a guaranteed minimum rate of return of around 1,5% per year over the holding period (compared to 0,1% for 10 year inflation linked German bonds for example). Public domestic banks would guarantee the minimum interest rate and the redemption of these savings bonds provided these savings are held for a sufficiently long period of time (e.g. until the retirement of the saver) and are invested in diversified portfolios notably in euro area equities.

4. Improving macro supervision to prevent and correct, early on, nascent private credit bubbles, especially in debt-prone countries

The implementation of the Banking Union provides an opportunity to improve macro supervision in the SSM countries. Macro prudential oversight was perhaps the most innovative concept of the de "de Larosière report" but we believe that the operational efficiency of the European Systemic Risk Board (ESRB) has not lived up to the expectations that has presided over its establishment. The present financial environment provides many sources of systemic risks and opportunities to reflect upon. We have seen in the recent past how the conjunction of low interest rates and high liquidity can end up in financial turmoil.

We think that it should not be another "layer" added on top of multiple national entities: it should have a specific- and a leading- role to play. In order to achieve such a mission, the EU needs to simplify and streamline the too complex and heavy system in place, separate it from the ECB, revisit the present administrative organization while seeking the best way of having the entity interact with the different players (i.e. central banks and regulators), be able to advise and relate with national bodies (central bankers, regulators and state treasuries), provide it with a committed independent managing Director who could actively work and interact with supervisors as well as national Treasuries (in particular by organizing meetings with specific states of the full members of the economic and financial Committee).

5. Distinguishing between liquidity crises and solvency crises for States

In a solvency crisis, the country cannot repay its debts; in a liquidity crisis, the country is solvent, but can no longer find financing on the financial markets under normal conditions. If a country is affected by a solvency crisis and it is assumed to be a liquidity crisis, this will have catastrophic effects because the other countries and international institutions will lend more to this country even though it is insolvent.

This has clearly been the case for Greece, which was affected by a fiscal solvency crisis in 2008-2009 (public debt climbed from 110% of GDP to 160% of GDP from 2007 to 2010) and an external solvency crisis (external debt reached 100% of GDP in 2007). Any experienced observer could have seen that Greece's debt was simply unmanageable and a restructuring was needed. However, bailout plans are being put in place for Greece by lending it more money (73 billion for the first plan, 177 billion for the second) instead of recognising that Greece has a solvency issue and extensively restructuring its debt from this date, which Europeans have not been willing to do. The restructuring of private debt, negotiated in 2011, has fallen short of what is needed for Greece to be able to embark on its recovery programme with healthy foundations and reasonable chances of success.

6. Toward fiscal integration: Envisaging the issuance of Eurobonds

When sufficient progress has been achieved on the fiscal front (balanced budgets) and genuine lasting confidence has been established between the Eurozone's Member States, it would be politically easier to envisage issuing Eurobonds. This would not be a mutualisation of bad risks. It would help countries having achieved fiscal balance to finance at lower spreads their "normal" (that is less than 60 percent of GDP) refinancing needs; by definition, no "new" indebtedness would benefit from this mechanism: indeed any measures leading to additional deficits would be, on the contrary penalised by markets. Strict rules would have to be enforced with a strong collective surveillance and the possibility of an exclusion from Eurobonds financing.

Moving towards a politically binding decision making process.

On the institutional plane, since national budgets are vetted at the Union level, at one point, it would make sense to move toward a politically binding decision making process. A "Commissioner Minister" or a permanent President of the Eurogroup notably responsible of economic and fiscal affairs would coordinate and supervise fiscal and structural policies, have the means to act in cases of national deviations or violations, and be accountable to the EU Parliament. This could lead to a more democratic setting. Is this totally infeasible? Not necessarily. In any case, the must avenue must be explored and effort should be undertaken to make it acceptable.

Conclusion

In sum the Eurozone has to embark on the right course: more fiscal responsibility and integration, and more supply side reforms geared to increase productivity as well as steps to complete the Banking Union and implement the Capital Markets Union. But this move to integration can only be politically envisaged if sufficient fiscal discipline were – in a tangible manner- to start reversing the trend of ever growing debt burdens.

To be viable, Eurozone needs:

- **Budgets kept under control**
- **Collective supervision of competitiveness; this would bring more balance in the working of the system**
- **As a last resort, some limited transfers, which would be relied upon in cases of asymmetric external shocks (independent from discretionary policies). But this can only occur once trust has been restored across countries and within countries.**

This model implies both the political will to move toward integration, and a high degree of acceptance of structural reforms and trust among members of the Union (trust that has been severely damaged). In sum, it implies that members of a monetary union must act together to make it work, and not behave as passive individual bystanders hoping that things will turn our fine.

[1] Federalism, i .e. automatic income transfers from the high-income countries to the low-income countries, contributes to the convergence of living standards in a monetary union: the larger the purchasing power differentials, the larger the transfers would have to be. But in the Eurozone, the degree of federalism is low.

[2] Until the sovereign crisis (2010), fiscal deficits increased everywhere but to different degrees (they became excessive in Greece and Portugal) and competitiveness problems worsened in a number of countries (Greece, Portugal, Spain, Ireland, France and Italy) due notably to an excessive private credit expansion and too rapid an increase in wages (relative to Germany) in relation to the increase of productivity (relative to Germany).

These discrepancies were encouraged by the blindness of financial markets which behaved as if all members of the Union formed a single block (countries with severe imbalances saw no increase in their spreads). Those discrepancies were compounded by the fact that common interest rates were too accommodating in countries where inflation was running higher than in Germany.

[3] See P. Artus: "The results of the euro to date for Spain, Portugal and Greece", Flash Economics, NATIXIS, July 8, 2015.

[4] With the EFSF and the ESM, the euro area has built a firewall of €700 billion that was able to contain and overcome a crisis that threatened 5 Member States and that seemed to put in peril the very existence of the euro.